Internal Revenue Service
MEMORANDUM

CC:DOM:P&SI:8
FKBoland SPR-118787-97

date: FEB 13 1998

to: National Director
Excise Taxes CP:EX:ST:E

from: (signed) Richard A. Kook
Chief, Branch 8
Office of Assistant Chief Counsel
(Passthroughs & Special Industries) CC:DOM:PSI:8

subject: Penalty calculations under § 6715

[NOTE: The opinions expressed in this memorandum are advisory only and do not represent the views of this office with respect to any particular taxpayer. This memorandum is not to be furnished to taxpayers and is not to serve as the basis for closing a case.]

As a result of our October 6, 1997, meeting, we have reconsidered an August 20, 1997, memorandum we prepared regarding the application of the penalty imposed by § 6715(a)(2) of the Internal Revenue Code on dyed fuel that is used or held for a taxable use. That memorandum described how to determine the number the gallons involved in a violation and how to apply the multiple violation rule.

This memorandum replaces the August 20 memorandum.

LAW

Section 6715(a)(2) provides that if any dyed fuel is held for use or used by any person for a use other than a nontaxable use and such person knew, or had reason to know, that such fuel was so dyed, then such person shall pay a penalty in addition to the tax (if any).

Section 6715(c)(2) provides that nontaxable use includes any use that is exempt from the tax imposed by § 4041(a)(1).

Section 6715(b)(1) provides that the amount of the penalty on each act is the greater of (A) $1,000, or (B) $10 for each gallon of the dyed fuel involved. Thus, the penalty always is at

least $1,000 when the amount of dyed fuel involved is not greater than 100 gallons.

In determining the penalty on any person, § 6715(b)(2) provides that the amount in paragraph (b)(1)(A) is increased by the product of $1,000 multiplied by the number of prior penalties (if any) imposed by § 6715 on such person (or a related person or any predecessor of such person or related person).

Section 6715(d) provides that if a penalty is imposed under § 6715 on any business entity, each officer, employee, or agent of such entity who willfully participated in any act giving rise to such penalty shall be jointly and severally liable with such entity for such penalty.

Section 4041(a)(1) imposes a tax on any previously untaxed liquid (other than gasoline) that is sold for use or used as a fuel in a diesel-powered highway vehicle. Section 48.4082-4(a) provides that this tax is imposed on the delivery of the liquid into the fuel supply tank of the vehicle. Under § 48.4082-4(a)(2), the operator of the vehicle into which the fuel is delivered is liable for this tax.

ANALYSIS

Elements of a § 6715(a)(2) offense. A violation of § 6715(a)(2) occurs if (1) a person held for use or used dyed fuel, (2) for a use other than a nontaxable use, and (3) the person knew, or had reason to know, that the fuel was so dyed.

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1. Dyed fuel is used when it is placed into the fuel supply tank of a vehicle. Dyed fuel in a user's bulk storage tank can be subject to the penalty only if the fuel is held for other than a nontaxable use.

The following example can be used to illustrate this point: A Diesel Compliance Officer (DCO) inspects a farmer's registered pick-up truck on the highway and determines that the truck holds 30 gallons of dyed fuel. The DCO then proposes a penalty of $1,000. The DCO also determines that the farmer fueled the truck from the farmer's bulk storage tank that contains 10,000 gallons of dyed fuel. While at the farm, the DCO observes numerous pieces of off-highway farm equipment that are fueled from the same bulk storage tank.

In this example, it is not improper for a Diesel Compliance Officer (DCO) to initially presume that the entire volume of fuel in the tank is held for a taxable use. However, this presumption is rebuttable. Thus, before the penalty is actually assessed, the taxpayer should be allowed to present its case to the DCO, the DCO's manager, or other IRS officials who have authority to determine the matter.

If the taxpayer does not present any evidence of nontaxable use, or if the evidence presented is not credible or otherwise unconvincing, it is not unreasonable for the IRS to base its assessment on the entire 10,000 gallons of dyed fuel in the tank.

On the other hand, if the taxpayer does present credible and convincing evidence of its past usage, this evidence can be used by the IRS to infer a pattern of future usage. Thus in the example, if the taxpayer can show that, historically, only 60% of the diesel fuel it dispenses from a bulk tank of dyed fuel is used for nontaxable purposes, it might be reasonable to assess the penalty on 40% (4,000 gallons) of the dyed fuel in the bulk storage tank even though those gallons have not yet been used. Note, however, that this result might not be appropriate if the taxpayer has established a new pattern of usage that is not consistent with its past practices.

Additionally, another way to use credible and convincing evidence of a taxpayer's past usage is to base the penalty on the use of dyed fuel that the taxpayer has actually used for a taxable purpose. For example, if it is determined that the taxpayer bought and used 100,000 gallons of dyed fuel during the previous year and that, historically, only 60% of the diesel fuel it dispenses from its bulk tank is used for nontaxable purposes, it might be reasonable to assess the penalty on 40% of that amount (40,000 gallons) that was actually used for a taxable use.

Note that the three possible results described in this example are not necessarily the only results that are reasonable ~~in any particular case. The facts of each case will be different~~ and should be resolved on its own merits.

2. Nontaxable use has the same meaning given to the term by § 4082(b). For example, nontaxable use includes any use in a nonhighway vehicle, or a highway vehicle that is not registered or required to be registered for highway use, even if these types of vehicles are actually used on the highway.

3. The § 6715(a)(2) penalty does not apply if the person otherwise liable for the penalty did not know or have reason to know that the fuel involved was dyed. It is not improper for a DCO to initially presume that a person in possession of dyed fuel has reason to know that its fuel is dyed.

However, this presumption is rebuttable. Thus, before the penalty is actually assessed, the taxpayer should be allowed to present its case to the DCO, the DCO's manager, or other IRS officials who have authority to determine the matter.

If the taxpayer does not present any evidence regarding its lack of knowledge, or if the evidence presented is not credible or otherwise unconvincing, it is not unreasonable for the IRS to

conclude that this element of the offense has been met.

In some cases, however, a taxpayer might be able to show that it had no reason to know that its fuel was dyed because it can show that the fuel was supplied by a reputable dealer, the fuel was not sold at a tax-excluded price, no written or oral statement was made to indicate that the fuel was dyed, and there was no visible spillage of dyed fuel when the fuel was delivered. If the evidence presented by the taxpayer is credible and convincing to the IRS, then this element of the offense would not be met and the penalty would not apply.

Number of gallons of dyed fuel involved. Under § 6715(b)(1), the calculation of the penalty is based on the number of gallons involved in each act of dyed fuel that is "held for use or used by any person" for a taxable use. This amount may be readily determined at a typical inspection of the fuel supply tank of a vehicle that has been stopped at an inspection site.

Difficulty may arise, however, when more than one container of dyed fuel is present at a place of inspection (for example, at a trucking company with several vehicles and a bulk storage tank). In these circumstances, DCOs have questioned whether the fuel in each vehicle should be counted separately or whether all the dyed fuel held for a taxable use that is discovered at an inspection site should be aggregated.

Under § 6715(b)(1), the amount of penalty is based on each act performed by a taxpayer that violates § 6715(a). An individual act would include the delivery of dyed fuel into the fuel supply tank of a highway vehicle or the placing of dyed fuel into a bulk container for eventual use in a taxable use.

Consider, for example, an inspection at a trucking company where a DCO discovers 50 gallons of dyed fuel in the fuel supply tank of a registered highway vehicle, 75 gallons of dyed fuel in the fuel supply tank of another registered highway vehicle, and 500 gallons of dyed fuel that is held for a taxable use in a bulk storage tank. In such a case, three acts in violation of § 6715(a) have been performed by the company and the total penalty that would be imposed (assuming no multiple violation issue, discussed later) is $7,000 ($1,000 for the vehicle containing 50 gallons + $1,000 for the vehicle containing 75 gallons + $5,000 for the 500 gallons in the bulk storage tank).

Multiple violations. Section 6715(b)(2) sets forth a formula for increasing the $1,000 minimum penalty imposed on a person if a prior penalty has been imposed by § 6715 on that person.

You suggest that a penalty is imposed on the date that the DCO's manager determines that all of the elements of the § 6715(a) infraction have been met. Under this approach, a potential infraction will not be counted as a "prior penalty" until the IRS confirms, through laboratory analysis, that the fuel actually is dyed and the taxpayer has had an opportunity to raise any defenses that might be available. Once these steps have been taken and the manager makes a taxpayer-adverse determination, then that penalty will be considered in determining the amount of any future penalty assessment against the same person.

We have no objection to this approach.

Person liable for the penalty. Both the § 4041 back-up tax and the § 6715(a)(2) penalty are imposed when dyed fuel is "used" for other than a nontaxable use. The regulations under § 4041 indicate that such a use occurs when the fuel is delivered into the fuel supply tank of a diesel-powered highway vehicle for a purpose other than a nontaxable use. Similarly, the act of delivering dyed fuel into the fuel supply tank of a diesel-powered highway vehicle is a use of the fuel for purposes of § 6715.

When an employee/driver of a trucking company delivers dyed fuel into the fuel supply tank of a company vehicle, the question is often raised whether the company is liable for the penalty. In making this determination, it is not unreasonable to apply traditional tort law principles. Under these principles, an employer can be liable for the wrongdoing of its employee committed in the course of employment, even though the employer has not specifically authorized the offending conduct. However, when an employee has so far departed from the employer's instructions that the employee has embarked on a "frolic of his own," the employer will not be liable. For example, when the employee's actions are motivated by a desire to enrich the employee rather than to serve the employer, then the employer might not be liable. The facts of each case will be different and should be resolved on its own merits.

Note that when the employer is liable for the penalty, § 6715(d) provides that any employee who willfully participated in any act giving rise to such penalty is jointly and severally liable with the entity for such penalty.

Differences between the back-up tax and the penalty. Under § 48.4082-4(a), the back-up tax imposed by § 4041 applies to previously untaxed liquid that is delivered into the fuel supply tank of a vehicle for a taxable use. Unlike the § 6715(a)(2) penalty, the back-up tax does not apply to fuel that is merely held for such use.

The back-up tax is imposed even if the operator of the vehicle did not know or have reason to know that the fuel was dyed. Conversely, the § 6715(a)(2) penalty is not imposed if the operator did not know, or have reason to know, that the fuel was dyed.

The penalty is assessed by the service center and is payable upon notice and demand. The back-up tax is payable on Form 720 under the usual rules for deposits, payments, and returns of § 4041 taxes. Note, however, § 40.6011(a)-1(b)(2)(v) allows the IRS to demand a return on a semimonthly basis.

If you have any questions about this, please contact Frank Boland at (202) 622-3130.